1/1. Examinable syllabus guide for

DECEMBER 2024 TO JUNE 2025 according to ACCA

Accounting policies, changes in accounting estimates and errors

- Identify items requiring separate disclosure, including their accounting treatment and required disclosures.
- Recognise the circumstances where a change in accounting policy is justified.
- Define prior period errors.
- Account for the correction of errors and changes in accounting estimates and changes in accounting policies.

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. Qualitative characteristics of useful accounting information

<table>
<tr><th colspan="2">Qualitative characteristics of useful accounting information</th></tr>
<tr><th>Fundamental qualitative characteristics</th><th>Enhancing qualitative characteristics</th></tr>
<tr><td>1. Relevance;
Predictive value, confirmatory value or both and material.</td><td>1. Comparability;
Consistency aids comparability</td></tr>
<tr><td rowspan="3">2. Faithful representation;
Completeness, neutrality and free from error.</td><td>2. Verifiability;</td></tr>
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Classifying, characterising and presenting information clearly
And concisely.</td></tr>
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1/3. Importance of consistency *and* comparability in financial reporting

1. **Comparability** is one of **enhancing qualitative characteristics** of accounting information.

2. **Comparability** among F/S[s] is an important **objective** of financial reporting.

3. **Comparability** is **enhanced** *through* **consistency** in application of the **same accounting policies** from year to year in the preparation of F/S[s].

4. IAS # 8 **requires** the presentation of prior year's F/S[s] for **comparative** purposes.

5. For information to be **comparable**, like things must look alike and different things must look different.

6. *While* full **comparability** will **not** be achieved *as long as* **alternative** principles of accounting and reporting for like transactions *and* events remain available; the IASB strives to **reduce alternatives** within IFRS Accounting Standards to **enhance comparability** among F/S[s] produced by essentially similar entities to facilitate informed economic decision making by F/S[s] users.

7. IAS # 8 attempts to **reduce** the risk of non-**comparability** by ***requiring***:

A. Retrospective application *when* **justifiably** adopting **new accounting policies**; ***and***

B. Retrospective restatement of prior periods' F/S[s] for corrections of errors.

To achieve transparency *and* **enhance** inter-period **comparability** of information in F/S[s] which **enhances** its decision usefulness.

8. There is a general **presumption** that the **benefits** derived from **restating comparative** information will **exceed** the resulting **cost** *and* **effort** of doing so.

1/4. Scope of IAS # 8

1. The accounting *and* disclosures of **accounting changes** (**change in accounting policy and change in accounting estimate**);

2. The accounting for the **correction of errors** (**errors** are not considered an accounting change).

2/1. '<u>Accounting policies</u>'

1. **Accounting policies** are **specific** <u>principles</u>, <u>bases</u>, <u>conventions</u>, <u>rules</u> *and* <u>practices</u> adopted by an entity in **preparing** *and* **presenting** the F/S^s.

2. Per IAS # 1 the entity's **management** is responsible for selecting *and* applying **accounting policies *that***:

A. Present fairly financial position, results of operations *and* cash flows of the reporting entity;

B. Present financial information in a manner that is **relevant, reliable, comparable** *and* **understandable**;

Thus; **Management** should **select** among acceptable alternative **accounting policies those polices** that reflect the **economic reality** of transactions *and* events presented in the F/S^s.

3. Because **disclosures** of chosen **accounting policies** is an essential for a **proper understanding** of the information contained in the F/S^s; **management** is **required** to **disclose** in the **notes** to the F/S^s a description of **all significant accounting policies** of the reporting entity.

Thus; '**Summary of significant accounting policies**' is customarily (*but not necessarily*), the **first** note **disclosure** included in the F/S^s.

2/2. Consistency of applying accounting policies

1. IAS # 8 states that:

> In preparation of the F/S[s] there is an **underlying presumption** that an **accounting policy** once adopted should **not** be changed from period to period *but rather* is to be **uniformly applied** in accounting for transactions *and* events of a **similar type** *without exception* ***unless*** the **changes** can be **justified** *or* **promulgated** by new standards.
>
> ....
>
> This **consistency** in **application** of **accounting policies enhances comparability** *and* enables users to identify **trends** in the entity's F/S[s] for **predictive** purposes.

***Thus*: Changes in accounting policy are only permitted *if*:**

A. The **voluntary** change will result in more **relevant** *and* **reliable** presentation of transactions *or* events in the F/S[s] of the reporting entity *such as* a Sub's changes its **accounting policies** *when* being newly acquired by a group that uses different **accounting policies** (the change is **justifiable**) ***or***

B. The change is **required** by a new IFRS Accounting Standard ***or*** an interpretation;

Illustrative example: Milan computerised its accounting system. (FIFO) method **were used** for inventory valuation under manual system, the computerised system which is ***tailor-made for the industry*** to which Milan belongs is capable of valuing inventories under weighted average (W.A) method **only** and is not equipped to value inventories under FIFO.

Required: Does Milan **change** of inventory valuation **policy** is justifiable?

Answer: **Yes because industry best practice dictates** that **only W.A is appropriate**. This is a **voluntary justifiable change in accounting policy** from FIFO to W.A because it results in F/S[s] providing **reliable** *and* more **relevant** information (inventory *and* cost of sales are **comparable** to other entities within the industry to which the entity belongs).

2. Examples of changes in accounting policies:

A. A change in inventory costing from 'W.A' to 'FIFO' *or* vice versa under IAS # 2 'Inventories';

B. A change from **cost model** to **F.V model** of accounting for investment property under IAS # 40'Investment property';

C. A change from **cost model** to **revaluation model** of accounting for PPE *and* intangible assets under IAS # 16 'PPE' *and* IAS # 38 'Intangible assets'

Note that; Provisions of IAS # 8 are **not** applicable to the **initial adoption** of revaluation model for PPE *and* intangible assets *although* such adoption is indeed a **change in accounting policy**. *But* **initial change** from cost model to revaluation model is dealt with in accordance with the provisions of IAS #16 / IAS # 38 *as appropriate.*

D. A change from **F.V** to proportionate share of the value of net assets acquired for valuing non-controlling interest (NCI) in business combinations (IFRS Accounting Standard # 3).

3. A **change in accounting policy** requires adequate **disclosures** of the **nature** of the **change** and its **effects**.

4. Two types of events do **not** constitute a **change in accounting policy** under IAS # 8:

A. Adopting an **accounting policy** for a **new type** of transactions *or* events **not dealt with previously** by the entity; ***and***

B. Adopting **a new accounting policy** for a transaction *or* event which was **not** material in prior periods.

2/3. Change in an accounting policy *and* 'Retrospective application'

1. *If* **initial application** of an **accounting policy** is made consequent to the **enactment** of a **new** IFRS Accounting Standard; the **change in** the **accounting policy** is accounted for in accordance with the **transitional provisions** set out in that standard.

In the **absence** of any specific **transitional provisions** in a new standard, a **change in** an **accounting policy** is to be applied **retrospectively**.

2. **Voluntary changes in accounting policy** are accounted for by **retrospective application**.

> **Retrospective application** of a new **accounting policy** *means* applying the new **accounting policy** to past transactions, events *and* conditions ***as if*** that **policy** has always been applied (***unless*** it is **impracticable** to do so).

3. Steps required for retrospective application

Illustrative example (1): Previously, Adam **expensed** its borrowing costs. Before F/S[s] of 2019 issuance, Adam intended to **capitalise** these borrowing costs relating to a factory under construction. The change is made **to be consistent with industry practice**.

Borrowing costs related to this construction that **expensed** were; $4,000 before 2018, $2,500 during 2018 *and* $3,000 for 2019.

The Statements of P/L **before retrospective application** for 2018 *and* 2019 **before** adjusting for **policy change** are as follows:

Description	2018	2019
Operating profit	**$20,000**	**$30,000**
Finance cost	**(3,800)**	**(4,800)**
Profit before tax	16,200	25,200
Tax expense **(20%)**	(3,240)	(5,040)
Net profit for the year	**12,960**	**20,160**

The 2018 opening R.E[s] were $15,000 and $18,000 share capital, no other components of equity *other than* R.E[s]

Note: Depreciation is not recognised as factory is **not** in use.

Statement of changes in equity before retrospective application						
Description	**2018**			**2019**		
	Share capital	**R.E[s]**	**Total**	**Share capital**	**R.E[s]**	**Total**
Beginning equity at 1, Jan, 2018	$18,000	$15,000	$33,000	$18,000	$27,960	45,960
Profit for the year	0	12,960	12,960	0	20,160	20,160
Ending equity balances	**18,000**	**27,960**	**45,960**	**18,000**	**48,120**	**66,120**

Required: Prepare the statement of P/L and the statement of changes in equity for the period-ended 31, Dec, 2019 with **comparatives**.

Answer:

Comparative statements of P/L-**retrospective application** for 2018		
Description	**2018 'as adjusted'**	**2019**
Operating profit	**\$20,000**	**\$30,000**
Finance cost	**(1,300)**	**(1,800)**
Profit before tax	18,700	28,200
Tax expense **(20%)**	(3,740)	(5,640)
Net profit for the year	**14,960**	**22,560**

Note: In presenting the previously issued F/S' (2018), the caption '**as adjusted**' is included in the column **heading**.

Statement of changes in equity-**retrospective application**						
Description	**2018**			**2019**		
	Share capital	**R.E' Restated**	**Total**	**Share capital**	**R.E'**	**Total**
Beginning **equity** balances as originally stated at 1, Jan, 2018	\$18,000	\$15,000	\$33,000	\$18,000	\$33,160	\$51,160
Plus : Change in accounting policy from expensing to capitalising borrowing costs **net of taxes** *	-	**3,200**	3,200	-	-	-
Beginning balances as restated	**18,000**	**18,200**	**36,200**	**0**	**0**	**0**
Profit for the year	0	14,960	14,960	0	22,560	22,560
Ending equity balances	**18,000**	**33,160**	**51,160**	**18,000**	**55,720**	**73,720**

***Adjusting the beginning R.E' balance net of tax for the earliest prior period presented** (1, Jan, 2018).

\$4,000 × 80% = **\$3,200**.

Cumulative adjusting entry

Dr: Construction in progress (\$4,000 + \$2,500 + \$3,000) = \$9,500

Cr: Income tax payable (\$9,500 × 20%) = \$1,900

Cr: R.E' (\$9,500 × 80%) = \$7,600

Illustrative example (2): Tefal changed its **accounting policy** in 2019 with respect to the valuation of inventories.

Up to 2018 inventories were valued using W.A cost method. In 2019 the method was changed to FIFO as it was considered to more accurately reflect the usage *and* flow of inventories in the economic environment.

The impact on change in inventory valuation was determined as follows:

Date	**Effect of change from W.A to FIFO on ending inventory**
31, Dec, 2017	An increase of \$10,000
31, Dec, 2018	An increase of 15,000
31, Dec, 2019	An increase of 20,000

The statements of P/L **before** retrospective application		
Description	**2018**	**2019**
Sales	$250,000	$300,000
Cost of sales	**(120,000)**	**(140,000)**
Gross profit	**130,000**	**160,000**
Selling and distribution costs	(20,000)	(25,000)
Administration expenses	(40,000)	(50,000)
Net profit	**70,000**	**85,000**

Required: Present the **change in accounting policy** in the Statement of P/L and the Statement of changes in Equity in accordance with the requirements of IAS # 8, *assuming* 1, Jan, 2018 R.E balance was $260,000. Ignore income taxes

Answer: Changes in inventory affects cost of sales as follows:

Effects of change from W.A to FIFO			
Description	**2017**	**2018**	**2019**
Changes in ending inventory	$10↑	$15↑	$20↑
Net effect on cost of sales	10↓	5↓	5↓
Net effect on profits	10↑	5↑	5↑

The statements of CI **after** retrospective application		
Description	**2018 'as adjusted'**	**2019**
Sales	$250,000	$300,000
Cost of sales	**(115,000)**	**(135,000)**
Gross profit	**135,000**	**165,000**
Selling *and* distribution costs	(20,000)	(25,000)
Administration expenses	(40,000)	(50,000)
Net profit	**75,000**	**90,000**

Note: In presenting the previously issued F/S^{s} (2018), the caption '**as adjusted**' is included in the column **heading**.

Statement of changes in R.E^{s}-retrospective application For the year-ended 31, Dec, 2019		
Description	**2018 Restated**	**2019**
Beg. R.E^{s} at 1, Jan, 2018, as originally stated	$260,000	**$345,000**
Add; Change in accounting policy for valuation of inventory	**10,000**	-
Beginning balances as restated	**270,000**	-
Profit for the year (profit for the year-ending 31, Dec, 2018 **as restated**)	75,000	90,000
Ending R.E^{s} balance	**345,000**	**435,000**

Note: The **cumulative** impact at 31, Dec, 2018 is an **increase** in R.E^{s} of $15,000 *and* $20,000 at 31, Dec, 2019.

Cumulative adjusting entry

Dr: Inventory $20,000

Cr: R.E^{s} $20,000

4. Changes in accounting policies sometimes *results in* **indirect effects** on the entity'^{s} F/S^{s} amounts from legal *or* contractual obligations *such as* profit sharing *or* royalty arrangements that could contain monetary formula based on amounts in the F/S^{s}.

IAS # 8 specifies that **indirect effects** are to be recognised in the period in which the entity makes the accounting change.

Illustrative example (3): Assuming a **change** in an **accounting policy** from WA inventory valuation to FIFO is adopted in the year-ended 31, Dec, 2019 and assume **comparative** 2018 F/S[s] **is to be presented** along with 2019 F/S[s].

Required: Discuss the required steps necessary for a **retrospective application** of the new **accounting policy**.

Answer:

A. Adjust the carrying amounts of the **opening balances for the earliest prior period presented (1, Jan, 2018)** of corresponding assets/liabilities *and* the offsetting effect on R.E[s] for the **cumulative effect of changing** to the **new accounting policy** on periods **prior to** those comparatively presented in the F/S[s] **(periods prior to 1, Jan, 2018)**;

B. Adjust the F/S[s] for the effects of **applying** the **new accounting policy** to that **comparative specific periods** presented **(year 2018)** by **retrospective application** of the **new accounting policy** to the affected items in those F/S[s] *as if* the **new accounting policy** had always been applied. And apply the new **accounting policy** in the year of **change (2019)**;

C. A **third statement (31, Dec, 2017)** of **SFP must** be presented as part of the **minimum comparative** information.

Retrospective application to prior periods is **required** *as long as* **it is practicable** to determine the effect of the change on the amounts in both the **opening** as well as **closing** SFP for **prior periods** (years before 2018 **and** 2018)

Illustrative example (4): In 2019 Bella decides to **switch** from FIFO to the W.A of inventory valuation. The statement of P/L for 2018 **under FIFO** was as follows:

Description	Subtotal	Total
Revenue		$900,000
Opening inventory	**235,000**	
Purchases	346,000	
Closing inventory	**(274,000)**	
Cost of sales		**(307,000)**
Gross profit		**593,000**

Opening inventory for 2018 based on WA would be $222,000 *and* closing inventory would be $243,000

Required: Restate statement of P/L for 2018 based on the W.A.

Answer:

Description	Subtotal	Total
Revenue		$900,000
Opening inventory	**222,000**	
Purchases	346,000	
Closing inventory	**(243,000)**	
Cost of sales		**(325,000)**
Gross profit		**575,000**

Notes:

1. Gross profit for 2018 will be reduced by $18,000.

2. The opening inventory for 1, Jan, 2019 will be $243,000 *rather than* $274,000.

3. The statement of changes in equity for 2018 will show $13,000 reduction to opening R.E[s] *due to* decreasing inventory from $235,000 under FIFO to $222,000 under W.A, ignoring income tax effects.

4. In order to prepare **comparative** figures for 2017 showing the change of **accounting policy**, it is necessary to recalculate the amounts for beginning inventory at1, Jan, 2017 under W.A.

Illustrative example (5): Cannon has recently adopted IFRS Accounting Standards *and* its existing policy of writing off of all **development expenditure** is no longer considered appropriate under IAS # 38 'Intangible assets'. The **new policy** to be first applied for the F/S[5] for the year-ended 30, Sep, 2020. Cannon will recognise development costs as an intangible asset *where* they comply with the requirements of IAS # 38. Amortisation of all qualifying development expenditure is on a straight-line basis over a **four-year** period **started from the year it occurs** (assuming $nil residual value).

The Statements of P/L **before retrospective application** of the **new policy** for 2019 *and* 2020 **before** adjusting for **policy change** are as follows:

Description	**Year-ended 30, Sep**	
	2019	**2020**
Revenue	$90,000	$95,000
Cost of sales	(35,000)	(37,000)
Gross profit	**55,000**	**58,000**
Operating costs	(10,000)	(11,000)
Operating profit	45,000	47,000
Development expenders	**(5,500)**	**(4,600)**
Finance cost	(2,500)	(2,400)
Profit before tax	37,000	40,000
Income tax expense (25%)	9,250	(10,000)
Net profit	**27,750**	**30,000**

The following are amounts of development costs **actually expensed** in P/L and the amounts that should be capitalised *and* amortised for the years-ending 30, Sep, 2018 to 30, Sep, 2020.

Date	**Amount recognised in P/L**	**Amount qualifying as an asset for amortisation**
In the year to 30, Sep, 2018	$5,000	$4,200
In the year to 30, Sep, 2019	5,500	4,600
In the year to 30, Sep, 2020	4,600	3,500

No development costs were incurred by Cannon prior to 2018. **Changes in accounting policies** should be accounted for under IAS # 8 '**Accounting policies, changes in accounting estimates** *and* **errors**'.

Required: Prepare statement of P/L for 2020 and **comparative** statement of P/L for 2019 on **retrospective basis** and extracts of Cannon's SFP for the years to 30, Sep, 2020 including the **comparative** figures to reflect the **change in accounting policy** *assuming* R.E[5] balance at 30, Sep, 2018 is $9,000.

Answer:

The statements of P/L **after** retrospective application		
Description	**Year-ended 30, Sep**	
	2019 'as adjusted'	**2020**
Revenue	$90,000	$95,000
Cost of sales	(35,000)	(37,000)
Gross profit	**55,000**	**58,000**
Operating costs	(10,000)	(11,000)
Operating profit	45,000	47,000
Development expenders	**(900) (1)**	**(1,100) (2)**
Amortisation of intangible assets	**(2,200) (3)**	**(3,075) (4)**
Finance cost	(2,500)	(2,400)
Profit before tax	39,400	40,425
Income tax expense (25%)	9,850	(10,106)
Net profit	**29,550**	**30,319**

(1) $5,500 - $4,600 = **$900**

(2) $4,600 - $3,500 = **$1,100**

(3) ($4,200 + $4,600) × ¼ = **$2,200**

(4) [($4,200 + $4,600 + $3,500) × ¼] = **$3,075**

Statement of R.E^s		
Description	**2019 Restated**	**2020**
Beginning R.E^s balance	**$9,000**	**$40,913**
Prior period adjustment net of tax (5)	**2,363**	**-**
R.E^s at 1, Oct, 2018 as restated	**11,363**	**-**
Net profit for the year	29,550	30,319
Ending R.E^s balance	**40,913**	**71,232**

(5) {[$4,200) incorrectly expensed in 2018] - [$4,200 × 25% amortisation for 2018]} × (1- T.R 25%) = **$2,363**

Description	2018	2019	2020	Total
Actually expensed development cost	$5,000	$5,500	$4,600	$15,100
Development cost should expensed	(800)	(900)	(1,100)	(2,800)
Amortisation of intangible assets	(1,050)	(2,200)	(3,075)	(6,325)
Excess expenses	3,150	2,400	425	**5,975**
Tax (25%)				**1,494**
Net increase in R.E^s for three years				**4,481**

Cumulative adjusting entry

Dr: Intangible assets ($4,200 + $4,600 + $3,500) = $12,300

Cr: Income tax payable $1,494

Cr: R.E^s $4,481

Cr: Acc. Amortisation $6,325

SFP			
Non-current assets	**2018 Restated**	**2019 Restated**	**2020**
Intangible assets	$4,200	$8,800	$12,300
Less: Acc. Amortisation	(1,050)	(3,250)	(6,325)
Net carrying value	**3,150**	**5,550**	**5,975**

2/4. Impracticability exception

1. **Retrospective application** is **not** required *if* it is **impracticable** to do so.

2. **Impracticable** is **very strictly defined** under IAS # 8 in order to preclude avoidance of **restating** earlier periods.

3. **Impracticable** *means* the entity **can't** apply the **retrospective application** of the new **accounting policy after** making every reasonable effort to do so.

4. In circumstances *where* **retrospective restatement** is deemed **impracticable**; the reporting entity will **disclose** the **reason** for **not retrospectively restating** the **comparative** amounts of prior periods.

5. Example of reasons that cause **retrospective restatement impracticable**:

A. The effects of the **retrospective application** are **not** determinable;

B. The **retrospective application** requires **assumptions** about what management's intentions would have been at that time;

C. The **retrospective application** requires **significant estimates** of amounts.

6. ***If*** it is **impracticable** to determine the effects of adoption of the new **accounting policy** on any prior period; the **new policy** is **applied prospectively** as of the earliest date that it is practicable to do so. (i.e.) the entity should go back as far as it can **and** the portion of the **cumulative adjustment** to affected assets, liabilities *and* R.E[s] **arising before** that date **is disregarded.**

Illustrative example: Prince is a manufacturing firm. During 2019 the directors decide to **change** the valuation method for raw material from W.A cost method to FIFO method. The effects on the value of the inventories are determined as follows:

Description	Weighted average	FIFO
31, Dec, 2018	$160,000	$140,000
31, Dec, 2019	190,000	160,000

Prince was **unable** to obtain figures as at 1, Jan, 2018 for inventory in terms of FIFO *due to* **impracticability**.

Ignore any income tax effects.

Required: Determine the **retrospective application**.

Answer:

Date	Effect of change from W.A to FIFO on ending inventory
31, Dec, 2018	A decrease of $20,000
31, Dec, 2019	A decrease of 30,000

Effects of change from W.A to FIFO		
Description	**2018**	**2019**
Changes in ending inventory	$20↓	$30↓
Net effect on cost of sales	20↑*	10↑
Net effect on profits	20↓	10↓

* The Effect of beginning inventory at 2018 on cost of sales **can't** be determined; the decrease of ending inventory by $20,000 at 2018 would increase cost of sales by the same amount. *Accordingly* **comparative** statement of P/L for 2018 **can't** be **presented retrospectively**.

Cumulative adjusting entry

Dr: Cost of sales $10,000 → **(P/L)** current year **(2019)**

Dr: R.E^s-opening balance $20,000 → presented as the first line item just next the beginning R.E of 2019

Cr: Inventories $30,000

Due to the **change in** the **accounting policy,** the carrying values of inventories decreased at 31, Dec, 2018 by $20,000 *and* at 31, Dec, 2019 by $30,000. The effect of this decrease in inventory is an increase in the cost of sales of $10,000 ($30,000 - $20,000) for the year-ended 31, Dec, 2019.

Note: *If* the figures for 1, Jan, 2018 were available; the **comparative** statement of P/L would also have been **retrospectively presented** for the **change in accounting policy**. *But* it was **not** presented because 2018 cost of sales can't be presented under FIFO due to **impracticability**.

2/5. Required disclosures

A. *if* the change in accounting policy is voluntary

A. The **nature** and the **reasons** for the change;

B. The **reasons** why applying the **new accounting policy** provides more **reliable** *and* **relevant** information;

C. Amount of the **adjustment** for the **current** period and for each **prior period presented;**

D. Amount of the **adjustment** relating to periods **prior** to those included in the **comparative** information; ***and***

E. The fact that **comparative** information has been **retrospectively restated** ***or*** that it is **impracticable** to do so and the circumstances that have made **retrospective** application **impracticable**.

B. *If* the change in accounting policy is made consequent to the enactment of a new IFRS Accounting Standard

A. The title of the IFRS Accounting Standard *or* interpretation;

B. The fact that the **change in accounting policy** has been made in accordance with the **transitional provisions** of the new/revised standard with a description of those provisions including the effects on future periods;

C. The **nature** of the change;

D. The **amount** of the **adjustment** for the **current** period and for each **prior period presented;**

E. The **amount** of the **adjustment** relating to periods **prior** to those included in the **comparative** information; ***and***

F. The fact that the **comparative** financial information has been **restated** ***or*** that **restatement** for a particular prior period has not been made because it was **impracticable**.

2/6. Changes in depreciation/amortisation methods

1. Tangible/intangible long-lived assets are subject to depreciation/amortisation respectively *while* a **change in** depreciation/ amortisation method would appear to be a **change in accounting policy** *but according to* IAS #16 and IAS # 38 a **change in** the depreciation/amortisation methods for **existing assets** is **deemed to be a change in** an **accounting estimate** *and* accounted for **prospectively**.

2. *When* the entity adopts a **different** depreciation/amortisation **method** for a **newly acquired** identifiable long-lived tangible/intangible assets and uses that **different method** for all **new** assets of the same class ***without*** changing the method used previously for **existing assets** of the same class; *Although* this is considered to be a **change in accounting policy** ***but*** no **retrospective adjustment** can be made to comparative F/S[s] *and* there is **no cumulative effect** on R.E[s] at the beginning of the earliest period presented, **because** the **different** depreciation/amortisation method is applied to the **new** assets *and accordingly* it would be **applied prospectively**. In this case a description of the **nature** of the depreciation/ amortisation method changed **and** the **effect** on P/L **and** related **per share** amounts should be **disclosed** in the period of the change.

3/1.Accounting estimates *and* 'Prospective application'

1. The use of **reasonable estimates** is an **essential part** of the F/S[s] preparation *due to* **inherent uncertainties** in business activities *and* does not undermine their **reliability**.

2. Change in accounting estimate is an **adjustment** of the **carrying amount** of an asset *or* a liability *or* the amount of the periodic consumption of an asset that results from the **assessment** of the present status of and expected future benefits *and* obligations associated with assets *or* liabilities.

3. Examples of change in accounting estimate:

A. Change in an asset service lives, residual values;

B. Change in F.V[s] of financial assets *or* financial liabilities;

C. Likely collectability of trade receivables (an estimate of the impairment of receivables *and* related bad debts);

D. Inventory obsolescence;

E. Provision for warranty obligations;

F. Provision for pension costs.

Note: An **impairment** affecting the cost recovery of an asset is **not a change in accounting estimate** *but* is treated as a **loss** of the period.

4. Changes in estimates will be highly likely to occur as **new information** ***and*** **more experience** is obtained ***or*** **circumstances change**. A **change in estimate** does **not** warrant **retrospective restating** the F/S[s] of the prior periods because it is **not** a **correction of** an **error**.

5. IAS # 8 **requires** that; a **change in** an **accounting estimate** is recognised **prospectively** by including the effects of **change** in P/L in the period of change *if* the **change** affects that period only *such as* a change in the % of doubtful accounts; ***or*** the period of change ***and*** future periods *if* the **change** affects both *such as* a change in estimated economic life of a depreciable asset.

Illustrative example: On 1, Jan, 2015 Falco purchased equipment for $600,000. It has estimated useful life of ten years *and* a residual value of $100,000.

On 1, Jan, 2019 Falco decided to review the useful life of the equipment and its residual value. Technical experts were consulted. According to them the **remaining** useful life of the equipment at 1, Jan, 2019 was eight years and its residual value was $80,000.

Required: Compute the revised annual depreciation for the year 2019 and future years.

Answer:

Carrying amount on 1, Jan, 2019 = $\$600{,}000 - \frac{\$600{,}000 - 100{,}000}{10\text{ Years}} \times 4\text{ years} = \$400{,}000$

Revised annual depreciation starting from the year-ending 31, Dec, 2019 = $\frac{\$400{,}000 - 80{,}000}{8\text{ Years}} = \mathbf{\$40{,}000}$.

Thus; **Prospective application** affects current year of change (2019) and future years. All prior period's depreciation would **not** be **restated** in **comparative** F/S^{s}.

6. The effect of a **change in** an **accounting estimate** should be included in the **same expense classification** as it was used previously for the estimate. This rule helps to **ensure consistency** between the F/S^{s} of different periods.

7. *According to* IAS # 8 ***when*** **it is difficult to distinguish** a **change** in an **accounting policy** from a **change in** an **accounting estimate**, the change is treated as a **change in** an **accounting estimate** with appropriate **disclosure**. For example a **change** from deferring *and* amortising a cost to recording it as an expense in the period it incurred because the future benefits of the cost have become doubtful. In this instance the entity is **changing** its **accounting policy** (from deferral to immediate recognition) because of its **change in** the **estimate** of the future utility of a particular cost incurred currently. *Thus*; it is treated as **a change in** an **accounting estimate**.

8. Disclosures:

A. An entity should **disclose** the **amounts** and **nature** of **changes in accounting estimates** that has a **material** effect in the current period *or/and* future periods.

B. ***If*** it is not possible to quantify the amount this **impracticability** should be **disclosed**.

4/1. Prior period errors

1. Prior period errors are **omissions from** *or* **misstatements** in F/S[s] for one or more **prior periods** arising from a **failure to use** ***or*** **misuse** of **reliable** information that **was available** at the time *when* the F/S[s] for those periods were authorised for issue **and** could reasonably be expected to have been obtained *and* taken into account in the preparation *and* presentation of those F/S[s].

2. Errors could result from:

A. Mathematical mistakes;

B. Mistakes in applying **accounting policies**;

C. Oversights;

D. Misinterpretations of available facts;

E. Use of unacceptable GAAP; ***and***

F. Fraud.

3. Error corrections requires '**retrospective restatement**' *where* prior periods F/S[s] **must** be **restated** to report financial position *and* results of operations as they would have been reported had the **error** never arisen (***unless*** **impracticable** to do so).

4. ***When*** **correcting** an **error** in prior periods F/S[s], the term '**restatement**' is to be used to effectively communicate to F/S[s] users of the **reason** for a particular change in previously issued F/S[s].

5. Retrospective restatement is **correcting** the **recognition**, **measurement** *and* **disclosure** of amounts related to elements of F/S[s] *as if* a **prior period error** had never occurred.

6. Materiality is the major criterion for **retrospective restatement**. **Materiality** depends on the **size** *and* **nature** of the omission *or* misstatement judged in the surrounding circumstances.

7. Omissions *or* misstatements of items are **material** ***if*** they could **individually** *or* **collectively** influence the economic decisions that users make on the basis of the F/S[s]. *If* the **correction** is determined to have a **material** effect on the results of operations *or* the trend of earnings; the F/S[s] should be **retrospectively restated**.

8. Intentional immaterial **errors** are considered **qualitatively material** *and* **require retrospective restatement**.

9. Changes in accounting estimates *and* **errors** are **not** the same, *where*:

A. Estimates are **approximations** that may need revision as **additional** information becomes known.

For example the ultimate outcome of a contingency would differ from previously estimated outcome. This does not constitute a **correction of** an **error** and can't be dealt with by **restatement**. ***However*** *if* the estimated amount of the contingency had been **miscomputed** from data available *when* the F/S[s] were prepared *then*; at least some portion of the variance between the amount accrued *and* the ultimate outcome might reasonably be deemed as an **error**.

B. Errors are omissions from *or* misstatements in the entity's F/S[s] for one *or* more prior periods discovered in the current period arising from a failure to use *or* misuse of **reliable** information that:

(♦): Was available *when* those prior periods F/S[s] were authorised for issue, ***and***

(♦): Could reasonably be expected to have been obtained *and* taken into account in the preparation *and* presentation of those F/S[s].

Illustrative example: The financial controller of Nirvana is concerned that some of the payments made this year are significantly larger than the amounts that were provided *and* accrued for. The two largest discrepancies are detailed below:

1. Legal experts had previously advised Nirvana that it would probably be found **not** liable in a court case concerning breaches in employee health and safety legislation. *As such* a **contingent liability** was **disclosed** in the F/S[s] for the period-ended 30, Sep, 2019. *However* on 1, July, 2020 Nirvana was found liable *and* was ordered to pay damages of $5m.

2. In its F/S[s] for the year-ended 30, Sep, 2019 Nirvana **provided for** income tax payable of $4m. *However* in Jan, 2020, Nirvana's records were inspected by the tax authorities *and* a number of **errors** were discovered. The tax authorities recommended that Nirvana improve its controls *and* training to prevent such mistakes from happening again. Nirvana was not levied with any fines *but* the authorities deemed that the correct amount of tax payable on profits earned in the period-ended 30, Sep, 2019 was $5.50m. Nirvana paid this in July, 2020.

Required: Discuss the correct accounting treatment of the above transactions for the year-ended 30, Sep, 2020.

Answer: IAS # 8 '**Accounting policies, changes in accounting estimates** *and* **errors**' says that; a **prior period error** is a misstatement in prior year's F/S[s] *resulting from* the misuse of information which should have been taken into account. **Prior period errors** are **adjusted** for by **retrospective restatement** of **comparative** amounts.

Changes in accounting estimates are accounted for **prospectively** by including the impact in P/L in the current period and *where relevant*, future periods.

1. The court case: This is **not** a **prior period error** because Nirvana had based its accounting treatment on the best information available. The payment of $5m will be **expensed** to P/L in the year-ended 30, Sep, 2020.

2. Tax: The **mistakes** made in the F/S[s] for the year-ended 30, Sep, 2019 should **not** have been made based on the information available to Nirvana. This *therefore* satisfies the definition of a **prior period error**. In the F/S[s] for the year-ended 30, Sep, 2019 the current tax expense *and* the income tax payable should both be increased by $1.50m on a **retrospective basis**.

10. An entity should correct **material prior period** error **retrospectively** in the first set of the F/S[s] authorised for issue **after** their discovery by:

A. **Restating** the **comparative** amounts for the **prior periods** presented in which the **error** occurred.

B. *If* the **error** occurred **before** the earliest prior period presented; the **opening balances** of assets, liabilities *and* R.E[s] for the **earliest** prior period presented is **restated**.

11. IAS # 1 was amended to **require** presentation of **two comparative SFP** *where* there is a **restatement** *as a result of* an **error**.

4/2. 'Retrospective restatement'

Illustrative example: Assume that Dragon had **overstated** its depreciation expense by $60,000 for the year-ended 30, Sep, 2018 *and* $90,000 for the year-ended 30, Sep, 2019 both *due to* mathematical **mistakes**. The errors affected both the F/S[s] *and* the income tax returns in the respective years *and* are discovered in 2020. Assume that only one **comparative** SFP is given. Dragon's SFP *and* statements of CI *and* R.E[s] for the year-ended 30, Sep, 2019 **prior** to the **restatement** were as follows:

Statement of P/L *and* R.E[s] **Prior** to restatement **Year-ended 30, Sep, 2019**	
Description	**Amount**
Sales	$3,000,000
Cost of sales	(1,400,000)
Gross profit	**1,600,000**
Depreciation expense	**(490,000)**
Distribution cost *and* administrative expenses	(510,000)
Profit from operations	**600,000**
Other income	10,000
Profit before income taxes	**610,000**
Income taxes (20%)	(122,000)
Net profit	**488,000**
Beginning R.E[s]	**4,200,000**
Dividends	(300,000)
Ending R.E[s]	**4,388,000**

SFP prior to restatement 30, Sep, 2019	
Description	Amount
Assets	
Non-current assets	
PPE-cost	$4,200,000
Acc. Dep	(1,430,000)
Net carrying value	2,770,000
Current assets	3,520,000
Total assets	**6,290,000**
Stockholders' equity *and* liabilities	
Shareholders' equity	
Ordinary shares	1,300,000
R.E^{s}	4,388,000
Total shareholders' equity	5,688,000
Non-current liabilities	270,000
Current liabilities	
Income taxes payable	120,000
Other current liabilities	212,000
Total current liabilities	332,000
Total liabilities	602,000
Total stockholders' equity *and* liabilities	**6,290,000**

Required: Restate prior period F/S^{s}.

Answer:

A. **Adjust** the carrying amounts of assets *and* liabilities at the **beginning** of the first period presented (1, Oct, 2018) in the F/S^{s} for the **cumulative effect** of the **correction** related to periods prior to those presented. with the offsetting effect is reflected in the **opening** balance of R.E^{s}

Adjusting entry to the beginning R.E^{s} of the first period presented (1, Oct, 2018):

Dr: Acc. Dep $60,000

Cr: Income tax payable ($60,000 × 20%) = $12,000

Cr: R.E^{s} ($60,000 × 80%) = $48,000

B. Adjust the F/S^{s} of each **individual** prior period presented (year-ended 30, Sep, 2019) for the effects of **correcting** the error on that **specific** period (referred to as the **period specific effects** of the error). The F/S^{s} are presented ***as if*** the error had never occurred. The restated F/S^{s} are presented below.

Statement of P/L *and* R.E[s] as **Restated** Year-ended 30, Sep, 2019	
Description	**Amount-restated**
Sales	$3,000,000
Cost of sales	(1,400,000)
Gross profit	**1,600,000**
Depreciation expense	**(400,000)**
Distribution cost *and* administrative expenses	(510,000)
Profit from operations	**690,000**
Other income	10,000
Profit before income taxes	**700,000**
Income taxes (20%)	(140,000)
Net profit	**560,000**
Beginning R.E[s] as originally reported	4,200,000
Add: Restatement to reflect correction of an error in depreciation expense	48,000
Beginning Restated R.E[s]	**4,248,000**
Dividends	(300,000)
Ending R.E[s]	**4,508,000**

SFP at 30, Sep, 2019 as **Restated**	
Description	**Amount-restated**
Assets	
Non-current assts	
PPE-cost	4,200,000
Acc. Dep	**(1,280,000)**
Net carrying value	**2,920,000**
Current assets	**3,520,000**
Total assets	**6,440,000**
Stockholders' equity *and* liabilities	
Shareholders' equity	
Ordinary shares	1,300,000
R.E[s]	**4,508,000**
Total shareholders' equity	**5,808,000**
Non-current liabilities	**270,000**
Current liabilities	
Income taxes payable	**150,000**
Other current liabilities	212,000
Total current liabilities	**362,000**
Total liabilities	**632,000**
Total stockholders' equity *and* liabilities	**6,440,000**

C. The following entry reflects the effect of the **restated** F/S' for the year-ended 30, Sep, 2019:

Dr: Acc. Dep $90,000

Cr: Income tax payable ($90,000 × 20%) = $18,000

Cr: R.E' ($90,000 × 80%) = $72,000

4/3. Impracticability exception

1. *According to* IAS # 8; *when* it is **impracticable** to determine the **cumulative effect** of a prior period's **error**, the entity presents the **comparative** information **retrospectively** only to the extent that it is practicable ***as if*** the **error** had been **corrected** from the **earliest date practicable**.

2. Impracticability *exception* is **not** an invitation to not **restate comparative** F/S[s] of the **prior periods** to remove the effects of **errors**. IAS # 8 sets out **strict criteria** of what constitutes **impracticability**.

4/4. Disclosures

When an accounting **error** is being **corrected** the entity is to **disclose** the following:

1. The fact that the F/S[s] have been **restated**;

2. The **nature** of the prior-period **error**;

3. The **amount** of the **correction** for each prior period presented;

4. The **amount** of the **correction** relating to periods **prior** to those presented in **comparative** F/S[s];

5. The effect of the **restatement** on each line item in the F/S[s];

6. The **cumulative effect** of the **restatement** on R.E[s];

7. *If* **retrospective restatement** is **impracticable** for a particular prior period; the circumstances that led to the existence of that condition should be **disclosed**.

These **disclosures** need **not** be repeated in subsequent periods

Illustrative example: In its 2019 annual accounts Gobles included the **corrected** 2018 consolidated cash flow figures as the **comparative** numbers to the 2019 consolidated cash flow statement. The 2019 F/S[s] did **not** include any reference to the fact that the **comparative** numbers accompanying the 2019 cash flow statement had been **corrected**. Gobles had issued a communication to the market about the **changes**.

Required: Discuss the implications of the above event.

Answer: The **changes** to the **comparative** figures were **material errors** and should have been **adjusted** in accordance with IAS # 8 *and* supported by the relevant **disclosures** which would have included **disclosure of** the **nature** of the prior period **errors**. *Even if* the **corrections** to the 2018 cash flow statement had been adequately communicated to the market *through* an announcement; **further disclosures** were necessary in the 2019 notes.

IAS # 1 state that; **in virtually all circumstances a fair presentation is achieved by compliance with applicable IFRS** Accounting Standard. The fact that relevant information has already been communicated to the market does **not** release Gobles from the obligation to apply IFRS Accounting Standard *when* preparing its annual accounts. A press announcement **can't** stand in the place of information that is required to be **disclosed** *and* audited within a set of annual F/S[s].

1/1. Examinable syllabus guide for DECEMBER 2024 TO JUNE 2025 according to ACCA

Operating segments

- Discuss the usefulness and problems associated with the provision of segment information.
- Define an operating segment.
- Identify reportable segments (including applying the aggregation criteria and quantitative thresholds).

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. The need of segment reporting

1. *Although* traditional **aggregated** F/S[s] enable users to assess the **overall** financial health of the entity *but* it **fails** to give them **relevant details** about the entity's **individual operations** *and* its **economic environment** in which **each component** operates. For example **diversified** *and* **multinational** entities produce a wide range of products/services, often in several different countries subject to different **risks**, **rewards**, opportunities for growth *and* future prospects.

So further information on how the **overall results** of these entities are made up from **each** of these products/services ***or*** geographical areas will **help F/S[s] users** to understand the entity's past performance *and* better assess the entity's **risks** *and* **returns** for **each component** enabling them to make more **informed judgements** about the entity as a whole.

Accordingly; **Segment reporting** is designed to reveal significant information that might be **hidden** by **aggregated** F/S[s].

Things we see from here are different from things we see from there

2. A **business segment** is a **distinguishable component** of an enterprise which provides an individual product *or* service (*or* group thereof) that is subject to **different risks** *and* **returns** from the other **business segments**.

3. IFRS Accounting Standard # 8 '**Operating Segments**' was issued on Nov, 2006 as part of the IASB's program of convergence with US GAAP. IFRS Accounting Standard # 8 **superseded** IAS # 14 '**Segment reporting**'. IFRS Accounting Standard # 8 is essentially the same as the U.S statement of financial accounting standard (SFAS) # 131'**Segment reporting**'.

4. Scope of IFRS Accounting Standard # 8:

A. IFRS Accounting Standard # 8 applies to **separate** *and* **consolidated** F/S[s] of **listed** entities whose **securities** are publically traded.

Notes:

- *When* a **listed** parent issues both **separate** *and* **consolidated** F/S[s]; segment information is **required only** in the **consolidated** F/S[s].

- ***If*** **a non-public entity voluntarily discloses segment information**; it **must** comply with IFRS Accounting Standard # 8 in **all** respects ***or*** the information **presented** in its F/S[s] **can't** be described as '**segment information**'.

B. IFRS Accounting Standard # 8 sets **three alternative quantitative thresholds; one must be met** for an **operating segment** to qualify as a **reportable segment**.

C. IFRS Accounting Standard # 8 sets out **disclosures** required for each **reportable segment** *and* also **require general** *and* **entity-wide disclosures** to reveal masked information in **aggregated** F/S[s].

5. The **core principle** of IFRS Accounting Standard # 8 is the **disclosure** of information that enable F/S[s] users to evaluate the nature *and* financial effects of the **individual business activities** of the entity *and* the **economic environment** in which it operates allowing them to understand the entity's main activities, *where* those activities are located *and* how well those activities are performing *and* making meaningful comparisons to prior periods.

2/1. Identify operating segments

An **operating segment** is a **component** of an entity with the following three key features:

A. Engages in business activities from which it may earn external *or* internal revenues and incur expenses; ***and***

B. Its operating results are regularly reviewed by a chief operating decision maker (CODM) who has power to make decisions about resources to be allocated to the segment and assess its performance, ***and***

C. For which discrete financial information is available to facilitate its performance review.

From the above features the following can be noted:

1. Chief operating decision maker (CODM) is a **function** not a manager with a specific title. That function has supervisory authority to allocate resources to the operating segments ***and*** assesses its performance.

2. CODM could be an **individual** *such as* chief executive officer (CEO) *or* chief operating officer (COO) ***or*** it may be a **group** of executive directors *or* executive committee.

3. *Where* the board of directors (BOD[5]) include some non-executive directors it may **not** be appropriate to classify the BOD[5] as the CODM because non-executive directors have governance role not a management role. They are **not involved** in the day-to-day activities *therefore* they do **not take decisions** *regarding* resource allocation.

Illustrative example: Franz is a listed entity. It has four major lines of business; manufacturing, retail, real estate *and* entertainment. Each major line of business has a COO who is responsible for the **business component's** profitability. The entity has a CEO who is in charge of the **entire business** of the entity *and* reports to the BOD[5] on the results of operations. The CEO has the authority from the Board to **decide on the performance bonus of each COO** for which the CEO has set key performance indications (KPI[5]) against which they are evaluated each year by the CEO. **Discrete financial information** for each major line of business is **available**. The CEO has been entrusted by the Board to **allocate funds** for the day-to-day operations of the four lines of business which he does based on **criteria** *such as* their comparative profitability, size of business generated *and* cash flows from operations.

Required: Based on the previous facts about the functioning of Franz *and* other relevant information provided. Who is the CODM for the purposes of IFRS Accounting Standard # 8? Is it the Board, the CEO or each COO for the line of business he *or* she is responsible for?

Answer: CODM has power to **make decisions** about **resources allocation** to the segment *and* assess its **performance**. CODM is a **function** not a manager with a specific title. The CODM could be an **individual** *or* a **group** of executive directors *or* executive committee.

A. The COO of each line of business is only responsible for the results of the line of business he *or* she is responsible for *but* is **not** responsible for the **overall business** of the entity. *Thus*; **each COO can't** qualify as the CODM.

B. *While* the Board is the highest authority in the hierarchy; the CEO has been **given the required powers** by the Board including the **power** of **resources allocation** *and* the **power** to assess the **performance** of the four business lines of the entity. According to the requirements of IFRS Accounting Standard # 8, the **CODM** is **not** the Board *but* is the CEO.

4. Under IFRS Accounting Standard # 8; **revenue generation** is **not** an absolute measure for an **operating segment**. Some **operating segments** may derive their revenue **solely** *or* **primarily** from other segments of the same entity *and if* they meet other requirements to qualify as **operating segments**, these segments can qualify as **operating segments**. *Thus*; under IFRS Accounting Standard # 8 the **operating segment** is **not** required to have revenues generated from **external** customers in order to be **classified** as an **operating segment** for financial reporting purposes.

Illustrative example: Centrica is a **publicly listed** auto dealership entity. Based on the decision of the BOD[5] Centrica is managed *and* controlled through three divisions. **Spare parts division**, **workshop division** *and* **sales division**. Both the sales division *and* the workshop division deal with **external customers** *and* handle orders of both walk-in customers *as well as* long-term customers who have purchased automobiles *through* this dealership. The entity's **spare parts division** only supplies spare parts to its workshop division *and* does **not** respond to the demands of any outside customers. The outside customers can't purchase spare parts directly from the spare parts division *unless* their vehicles are serviced by the workshop division *and* the workshop division purchases spare parts from spare parts division for the purposes of undertaking repairs of cars they have been contracted to undertake repair work for.

The **CODM** is the BOD[5] who **allocates resources** *and* **assesses performance** based on the results of the **three divisions** for which the entity's financial controller maintains **separate** *and* **discrete financial information**.

Required: Under IFRS Accounting Standard # 8 how many **operating segments** do Centrica have?

Answer: IFRS Accounting Standard # 8 states that; some **operating segments** may derive their revenue **solely** *or* **primarily** from other segments of the same entity *and if* they meet other requirements to qualify as **operating segments**; these segments can qualify as **operating segments** *and* reporting on the grounds that they do **not** derive their revenues from **external** sources. *Thus*; under IFRS Accounting Standard # 8 a segment is not required to have revenues generated from external customers in order to be **classified as** an **operating segment** for financial reporting purposes. *Therefore* under IFRS Accounting Standard # 8 **all three divisions** of Centrica qualify as **operating segments**.

5. Under IFRS Accounting Standard # 8; the following **business components** may **qualify** as **operating segments**:

A. Start-up operations *even if* that component of the entity is not yet earning any revenues from its operations;

B. A discontinued operation *if* it continues to **engage in business activities**, its **operating results** are still **regularly reviewed by** the **CODM** *and* there is **discrete financial information available** to facilitate its performance review;

C. External R&D operation can qualify as an **operating segment** *if* it provides **material** revenues. *While*; **internal R&D** is **not** an **operating segment**;

D. A functional department can qualify as an **operating segment** *if* it relates to **line position** *such as* selling *or* manufacturing departments (i.e. **not staff position** *such as* H.R *or* accounting department);

E. In situations *where* **all** *or* most of the segment's revenues *and* expenses are derived from **inter group transactions** these segments may qualify as **operating segments** (vertically integrated organisations).

6. According to IFRS Accounting Standard # 8 **not** every part of the entity is necessarily an **operating segment** *or* part of an **operating segment** for example:

A. Corporate headquarters (head office) is **not** an **operating segment** because it is **not** engaged **in business activities** (does **not** earn revenue *or* incur expenses in the ordinary course of business);

B. Certain functional departments that earn no revenues *or* generate **incidental** revenues relative to the activities of the entity as a whole *such as* the entity's cafeteria.

C. An entity's **postemployment benefit plans** including pension plan.

7. The identification of **operating segments** within entities has grown in complexity over the years especially in **conglomerates** that has '**matrix organisational structures**' *where* the internal managerial information system may generates reports in which business activities are **presented in a variety of ways**. For example the **CODM** uses information based on product *or* service **and** at the same time information based on geographical areas to review business activities.

The following matrix shows the entity's information system ability to present performance reports based on *either* products *or* geographical areas:

Products↓	Geographical areas →					Total
	G_1	G_2	G_3	G_4	G_5	
P_1	$XX	$XX	$XX	$XX	$XX	$XX
P_2	XX	XX	XX	XX	XX	XX
P_3	XX	XX	XX	XX	XX	XX
P_4	XX	XX	XX	XX	XX	XX
P_5	XX	XX	XX	XX	XX	XX
Total	XX	XX	XX	XX	XX	XX

Under these situations, the entity's management **must identify** a **single set** of **business components** on which to base the segment **disclosures**. The basis chosen should be the one that **best enables F/S' users** to understand the business *and* the environment in which it operates.

Accordingly; the **definition** of an **operating segment** under IFRS Accounting Standard # 8 **is based on** the entity's internal managerial reporting system that could be **substantially different** among entities in the **form** ***and*** **content** of the reports *and* information reviewed by the **CODM** in each entity.

> *Thus*; IFRS Accounting Standard # 8 adopts a **management approach** (not '**risks** *and* **rewards**' approach) **in determining operating segments**. *Accordingly* the **definition** of an **operating segment** under IFRS Accounting Standard # 8 is based on the entity's **business model** which could be significantly different from entity to entity → **disadvantage**.

8. Segment reporting by the entity should be **consistent overtime** to the extent possible in order to ensure **comparability** of **disclosures** from period to period.

2/2. Operating segments aggregation criteria

Two *or* more **operating segments** may **optionally** be **aggregated** into a **single operating segment** ***if:***

1. The **operating segments** have **similar economic characteristics** *such as* **similar** expected long-term average gross margins; ***and***

2. The **operating segments** are **similar** in **each** of the following aspects:

A. The **nature** of the products *and* services;

B. The **nature** of the production processes;

C. The type *or* class of customer for their products *and* services;

D. The methods used to distribute their products *or* provide their services; ***and***

E. *If applicable*, the **nature** of the regulatory environment, for example banking, insurance *or* public utilities.

Thus; IFRS Accounting Standard # 8 sets **strict criteria** for **aggregation** to prevent entities from inappropriate **over-aggregating operating segments** that could mask relevant detailed information.

Illustrative example: Bono is a French based entity that sells video games *and* hardware. Sales are made through the entity's website *as well as through* high street stores. The products sold online *and* in the stores are the same. Bono sell new releases of video games for €100 in its stores *but* for €80 online.

Internal reports used by the **CODM** show the results of the online business **separately** from the stores.

Required: Should the online business *and* the high street stores be **aggregated** into a **single operating segment**?

Answer: IFRS Accounting Standard # 8 says that; two *or* more **operating segments** may be **optionally aggregated** into a **single operating segment** *if*:

1. The **operating segments** have **similar economic characteristics** *such as* **similar** expected long-term average gross margins; ***and***

2. The **operating segments** are **similar** in **each** of the following aspects:

A. The **nature** of the products *and* services;

B. The **nature** of the production processes;

C. The type *or* class of customer for their products *and* services;

D. The methods used to distribute their products *or* provide their services; ***and***

E. *If applicable*, the **nature** of the regulatory environment, for example banking, insurance *or* public utilities.

♦ IFRS Accounting Standard # 8 says that; **operating segments** with **similar economic characteristics** would have **similar** long-term gross margins. Bono sells its product at **different** sales prices between the stores *and* the online business giving rise to **significant differences** in gross margins. This suggests **dissimilarity** in terms of **economic characteristics**.

♦ Bono stores *and* online business sell the same types of product *and* there are likely to be **no** major differences in the types of customer (individual consumers). *Therefore* in these respects, the **operating segments** are **similar**.

However customers will collect their goods from the stores *but* Bono will deliver the products sold online. This means that distribution methods are **different**.

Thus: it might be more appropriate to **not aggregate** these **operating segments**.

Note: For exam purposes; it is important to state the relevant **aggregation criteria** *and then* to apply these **criteria** to the information given in the question.

2/3. Not all operating segments would automatically qualify as Reportable segments

Although IFRS Accounting Standard # 8 does not specifically define **reportable** segments *but* it states that: a **reportable segment** is an **operating segment** *or* aggregations of two *or* more of such operating segments that:

1. Has been identified as meeting the definition of an operating segment; ***and***

2. Meets **any one** of the following **alternative** quantitative thresholds:

A. The segment's **combined revenue** (internal *and* external) is 10% *or* more of the **combined** revenue (external *and* intersegment) of all operating segments; ***or***

B. The absolute amount of its reported **profit** ***or*** **loss** is 10% *or* more of the greater of:

(I): The **combined** reported **profit** of all operating segments that did not report a loss, ***and***

(ii): The **combined** reported **loss** of all operating segments that reported a loss.

C. Its **assets** are 10% *or* more of the **combined assets** of all operating segment.

Only reportable segments give rise to the F/S[s] disclosures set forth by IFRS Accounting Standard # 8

Illustrative example: Below are details of the operating segments data that is provided to the CODM.

Segment	Total sales (revenue)	Profit	Loss	Assets
A	$600,000	$280,000	-	$400,000
B	450,000	-	$290,000	1,200,000
C	2,000,000	-	1,110,000	1,300,000
D	700,000	-	400,000	500,000
E	600,000	220,000	-	900,000
F	3,200,000	2,500,000	-	1,200,000
Combined	**7,550,000**	**3,000,000**	**1,800,000**	**5,500,000**

Required: Which of the previous operating segments represents a **reportable** segment?

Answer: A **reportable segment** is an **operating segment** *or* aggregations of two *or* more of such operating segments that:

1. Has been identified as meeting the definition of an operating segment; ***and***

2. Meets **any one** of the following **alternative** quantitative thresholds:

A. The segment's **combined revenue** (internal *and* external) is 10% *or* more of the **combined** revenue (external *and* intersegment) of all operating segments; i.e. 7,550,000 × 10% = **$755,000** ***or***

B. The absolute amount of its reported **profit *or* loss** is 10% *or* more of the greater of:

(I): The **combined** reported **profit** of all operating segments that did not report a loss i.e. **$3m**, ***and***

(ii): The **combined** reported **loss** of all operating segments that reported a loss i.e. **$1.80m.**

Thus; the 10% is based on $3m.i.e. **$300,000**;

C. Its **assets** are 10% *or* more of the **combined assets** of all operating segment i.e. $5.50 m × 10% = **$550,000.**

Segment	Total sales	Profit/Loss	Assets	Reportable segment
A	No	No	No	No
B	No	No	Yes	Yes
C	Yes	Yes	Yes	Yes
D	No	Yes	Yes	Yes
E	No	No	Yes	Yes
F	Yes	Yes	Yes	Yes

Conclusion: All operating segments *but* (A) are reportable segments.

2/4. '**Minimum**' 75% test

If the total **external** revenue reported by the identified operating segments that qualify as reportable segments are less than 75% of the entity's **external** revenue; additional operating segments must be identified as reportable segments *until* the **external** revenues of the reportable segments reaches at least to 75% of the entity's **external** revenue *even if* they do not meet the 10% quantitative thresholds.

Thus; IFRS Accounting Standard # 8 relaxed its requirements of meeting the 'alternative 10% quantitative thresholds' criteria *until* this minimum limit are reached.

Illustrative example (1): The management of Rivera 'a listed entity' identifies operating segments based on geographical location. Information for these segments is provided below:

Segment	Total Revenue	External Revenue	Internal Revenue	Profit/Loss	Assets
Europe	**$260**	**140**	**120**	**98**	**3,400**
Middle East	78	33	45	(26)	345
Asia	150	150	0	47	995
North America	330	195	135	121	3,800
Central America	85	40	45	(15)	580
South America	97	54	43	10	880
Totals	**1,000**	**612**	**388**	**235**	**10,000**

Required: According to IFRS Accounting Standard # 8; determine the reportable segments.

Answer:

Segment	10% test based on **combined revenue** $1,000	10% test based on **combined** reported **profit** $276	10% test of based on **combined assets** $10,000	Reportable segments
Europe	Yes	Yes	Yes	Yes
Middle East	No	No	No	No
Asia	Yes	Yes	No	Yes
North America	Yes	Yes	Yes	Yes
Central America	No	No	No	No
South America	No	No	No	No

Note: For profit *or* loss test:

A. The absolute combined profits of all operating segments that did not report a loss is $276.

B. The absolute combined loss of all operating segment that reported a loss is $41.

Thus; profit *or* loss test is based on $276.

Based on the 10% tests Europe, Asia *and* North America are reportable. *However* we must check *whether* they comprise at least 75% of Rivera's external revenue.

75% test	
Segment	**External revenue**
Europe	$140
Asia	150
North America	195
Totals	485

The **external revenue of reportable segments** is **79%** of **total external revenue** ($485/ $612). *Thus*; the **75% test** is met *and* no other segments need to be reported.

Conclusion: The **reportable segments** are Europe, Asia *and* North America.

Note: Geographical segments may be based on the location of the entity's operations (by **source**) *or* on the location of the entity's markets (by **destination**).

Illustrative example (2): Zola is a **listed entity**. The BOD[5] is responsible for all **key financial** *and* **operating decisions** including the **allocation of resources**. The BOD[5] receive a monthly report on the activities of the five significant operational areas of Zola based on **product line**. Relevant financial information relating to the five product lines for the year to 30, Sep, 2020 *and* in respect of the head office is as follows:

Operating segment (Product line)	External revenue for year to 30, Sep, 2020	Profit/(loss) for year to 30, Sep, 2020	Assets at 30, Sep, 2020
(1)	$23,000	$3,000	$8,000
(2)	18,000	2,000	6,000
(3)	4,000	(3,000)	5,000
(4)	2,000	150	500
(5)	3,000	450	400
Subtotal	**50,000**	**2,600**	**19,900**
Head office	**0**	**0**	**6,000**
Entity total	**50,000**	**2,600**	**25,900**

Required: Which of the above product lines should report separate information (considered **reportable segments**)?

Assuming product lines (1), (2) *and* (3) exhibit very distinct economic characteristics *but* the economic characteristics of product lines (4) *and* (5) are very similar

Answer:

1. For operating segments that have very similar economic characteristics:

If product lines (4) *and* (5) meet **all** of the **aggregation criteria**; they will be considered as **a single operating segment.**

2. Identifying reportable segments:

Operating segment (Product line)	External revenue		Profit/(loss)		Assets		Reportable segments
	Amount	%	Amount	%	Amount	%	
(1)	$23,000	46%	$3,000	53.60%	$8,000	30.90%	**Yes**
(2)	18,000	36%	2,000	35.70%	6,000	23.20%	**Yes**
(3)	4,000	8%	(3,000)	53.60%	5,000	19.30%	**Yes**
(4) *and* (5)	5,000	10%	600	10.70%	900	3.50%	**Yes**
Head office	**0**	N/A	**0**	N/A	**6,000**	N/A	
Entity total	**50,000**		**2,600**		**25,900**		
Test denominator	**50,000**	**100%**	**5,600**		**25,900**	**100%**	

Notes:

1. The head office does **not** meet the **definition** of an **operating segment** because it is **not** engaged in business activities *and* it does **not** earn revenue *or* incur expenses.

2. *Although* the head office does **not** satisfy **operating segment definition** *but* its assets are **included** for the **asset test**.

3. For **profit** *or* **loss** test:

A. The **absolute combined profits** of all **operating segments** that did **not** report a **loss** is **$5,600.**

B. The **absolute combined loss** of all **operating segment** that reported a **loss** is **$3,000.**

Thus; **profit** *or* **loss** test is based on **$5,600.**

3. The 75% Test

The total **external revenues** of the **reportable segments** constitute 100% of the total **external revenue.** ($50,000/ $50,000).*Thus;* the **75% minimum threshold** for **external revenue** test is satisfied. *Accordingly* no additional **operating segments** need be **identified** as **reportable segments.**

Illustrative example (3): Roma is a **listed entity**. The CEO is responsible for all key **financial** *and* **operating decisions** including the **allocation of resources**. The CEO receives a quarterly report on the activities of the five significant operational areas of Roma **based on product line**. Relevant financial information relating to the five product lines for the year to 30, June, 2020 is as follows:

Operating segment (Product line)	External revenue for year to 30, June, 2020	Profit/(Loss) for year to 30, June, 2020	Assets at 30, June, 2020
(1)	$4,800	$194	$100
(2)	4,900	(180)	200
(3)	4,700	(150)	300
(4)	4,600	(70)	400
(5)	31,000	1,806	4,000
Total	**50,000**	**1,600**	**5,000**

Required: Which of the above **operating segments** (product lines) should report separate information (considered **reportable segments**)?

Answer:

1. Identifying reportable segments:

Operating segment (Product line)	External revenue		Profit/(Loss)		Assets		Reportable segments
	Amount	%	Amount	%	Amount	%	
(1)	$4,800	9.60%	$194	9.70%	$100	2%	No
(2)	4,900	9.80%	(180)	9%	200	4%	No
(3)	4,700	9.40%	(150)	7.50%	300	6%	No
(4)	4,600	9.20%	(70)	3.50%	400	8%	No
(5)	31,000	62%	1,806	90.30%	4,000	80%	**Yes**
Total	**50,000**	100%			**5,000**	100%	

Note: For **profit** *or* **loss** **test**:

A. The **absolute combined profits** of all **operating segments** that did **not** report a **loss** is $2,000.

B. The **absolute combined loss** of all **operating segment** that reported a **loss** is $400.

Thus; **profit** *or* **loss** **test** is based on $2,000.

2. The 75% test:

The total **external revenue** of the **reportable segments** is **$31,000** which represents only 62% of Roma's **external revenue** ($31,000/ $50,000).*Thus*; the **75% minimum threshold** for **external revenue test** is **not** satisfied. *Accordingly*; additional **operating segments must be identified** as **reportable segments** *until* **total external revenue** of the **reportable segments** reaches **at least to75%** of Roma's **external revenue** *even if* they do **not** meet the 10% **quantitative thresholds**.

From above information; **operating segment** (2) is the **nearest segment** to satisfy the 10% of any of the three tests. The **external revenue** of the **operating segment** (2) is **$4,900**.

The **total external revenue** of the **reportable segments** would be **$35,900** ($31,000 + $4,900) which represents only 71.80% of the total **external revenue** ($35,900/ $50,000).

Again we need additional **operating segments** to satisfy the **75% minimum test**. **Operating segment** (1) is the second nearest segment to satisfy the 10% based on **profit** *or* **loss test**. The **external revenue** of the **operating segment** (1) is **$4,800**. The total **external revenue** of the **reportable segments** would be **$40,700** ($31,000 + $4,900 + $4,800) which represents 81.40% of the total **external revenue** ($40,700/ $50,000). *Accordingly* no additional **operating segments** need be **identified** as **reportable segments**.

2/5. The remaining operating segments

After the '**Minimum**' **75% test** is **satisfied**, for the **remainder operating segments** check *whether* any of the previously **identified operating segments** *or* **aggregated operating segments** meets the **majority** of the **aggregation** criteria. *If* they do, **aggregate them** *and* are **treated as a reportable segments** ***if* desired**.

Notes:

A. Individual operating segments can also be **treated as reportable segments** *even if* they are **not aggregated** with another segment *or* do not meet the **quantitative threshold**; *if* management believes that information about the segment would be **useful** to the F/S' **users**.

B. *Although* IFRS Accounting Standard # 8 did **not** determine the number of **reportable segments** *but* a **practical limit** could be 10 in order to avoid **information overload** to F/S' users.

2/6. 'All other segments' category

1. Information about other **immaterial** business activities *and* **operating segments** that are **not reportable** are combined into an **'all other segments' category** *and* **presented** in a **single column**. *Thus*; a catch-all ('all other segments') category should **not** be used *unless* truly **immaterial**.

2. 'All other segments' category is **not** a **reportable segment** as defined by IFRS Accounting Standard # 8.

3. The sources of the **revenue** included in the **'all other segments' category must be described**.

Summary of steps in the determination of reportable segments:

1. Identify operating segments based on management internal reporting system;

2. Determine *whether* any **operating segment meets all aggregation criteria** *and if so*; **aggregate** them *if* **desired**;

3. Review the **identified operating segments** *and* **aggregated** groups of **operating segments** *to determine if* each meet at least **one** of the **quantitative thresholds** (10% **thresholds**) to be **treated as a reportable segment**;

4. Test *whether* the **external** revenues of the **identified reportable segments** so far represent **75%** *or* **more** of the entity's **total external** revenue. *If* the total **external revenue** of **reportable segments** is **less than 75%** of the total entity's **external** revenue; *then* report **additional operating segments** *regardless* of 10% **quantitative thresholds**;

5. For the remainder, check *whether* any of the previously **identified operating segments** *or* **aggregated** groups of **operating segments** meet the **majority** of the **aggregation criteria**. *If they do*, **aggregate them** as a **reportable segment** ***if* desired**.

6. Individual operating segments can also be treated as **reportable segments** *even if* they are **not aggregated** with another segment *or* do not meet the **quantitative threshold** *if* **management believes** that information about such **operating segment** would be **useful to the F/S**[s] **users**.

7. Finally; **aggregate the remaining segments** into a **category** called **'all other segments'**. A **catch-all ('all other segments') category** title should not be used *unless* truly **immaterial**.

3/1. Other relevant points

1. IFRS Accounting Standard # 8 establishes how the entity report information about its **reportable segments** in its **annual** F/S[S] *and* **interim** reports.

2. IFRS Accounting Standard # 8 **requires** each entity to report **financial** *and* **descriptive** information about its **reportable segments** on the **same basis** the information presented to **CODM**. This approach would leads to putting users in the 'shoes of management' in their ability to evaluate management performance (i.e. See through the eyes of management). *Accordingly*; **segment reporting varies substantially** from entity to entity depending on its **internal structure of the information reporting system.** This would **impair** the F/S[S] user's ability to **compare disclosures** *regarding* **reportable segments** among entities.

Illustrative example: IFRS Accounting Standard # 8 states that; the entity should **report** (consider the **operating** segment as a **reportable segment**) an **operating segment's** internal *and* external revenues *if* its **combined revenue** comprises at least 10% of the **combined internal** *and* **external revenue** of '**all operating segments**'.

Required: What is meant by '**all operating segments**' stated above?

Answer: '**All operating segments**' means the total revenues of all **operating segments reviewed** by the **CODM**. The **total revenues** of all **operating segments** reviewed by the **CODM** not necessarily equal the total of consolidated revenues reported in the F/S[S] of the entity because information reported to the **CODM** for **performance evaluation** *and* **resource allocation** could be greatly different from information reported under IFRS Accounting Standards *and* it differs from entity to entity.

3. Information that is not prepared for internal use by the **CODM** need **not** be reported *if* it is **not** available *and/or* the cost to develop it would be excessive.

4. *If* an **operating segment** is **identified** as a **reportable segment** in the current period; **comparative** segment **data** for **prior period** should be **presented retrospectively** *unless* the prior period **comparative** information is **not** available *and/or* the cost to develop it would be excessive.

4/1. Problems with IFRS Accounting Standard # 8

Segment reporting provides useful information *but* also has limitations as follows:

1. Trading between segments may distort the results of each **operating segment** *particularly if* the transactions do not occur at **F.V.**

2. IFRS Accounting Standard # 8 states that; segments should reflect the way in which the entity is managed. This means that; **segment information** is **only** useful for **comparing** the **performance** of the **same entity over time** *but* **not** for **comparing** the performance of different entities.

3. The segmentation process is based on **management's perspective** *and* some users lack trust in management's intentions. For example management may attempt to **conceal loss-making areas** of the business within a larger profitable **reportable segment**.

4. The guidance around the **aggregation** of **operating segments** is **vague** *and* may lead to entities **over-aggregating** segments to **reduce the level of detail** that they are required to report.

5. Common costs may be **allocated** to different segments on *whatever* basis the directors believe is reasonable. This can lead to **arbitrary allocation** of these costs to **overshadow** segment results.

6. The **materiality threshold** for an **operating segment** to **qualify** as a **reportable segment** is basically set at one which contributes at least 10% of **combined revenue**, **profits/ loss** *or* **total assets**. Even with this guidance *however* **segment identification** is a somewhat **subjective exercise** *and* **comparisons** of segment information provided by different entities could be misleading.

5/1. Critical comments to IFRS Accounting Standard # 8

IFRS Accounting Standard # 8 was introduced as part of the IASB's program of convergence with US GAAP. It replaced IAS # 14. IFRS Accounting Standard # 8 is essentially the same as the FASB standard on segment reporting (SFAS #131). It was felt by many European users that IFRS Accounting Standard # 8 was indeed easier than IAS # 14 for entities to prepare *but* at the cost of promoting a **lower quality** of financial reporting.

The central criticisms of IFRS Accounting Standard # 8 are that;

1. IFRS Accounting Standard # 8 gives management **too much discretion** over how segment results are reported. The former IAS # 14 required entities to decide which segments were **reportable** on the **basis of segment's risks** ***and*** **returns** *but* IFRS Accounting Standard # 8 allows entities to report segments based on **internal organisation structure** alone.

2. IFRS Accounting Standard # 8 **reduced** the level of **compulsory disclosures** which is likely to **reduce the usefulness** of the information provided to users. Only a segment's **profit** *or* **loss** together with its **total assets** needs to be **disclosed**.

3. IFRS Accounting Standard # 8 eliminates the previous requirement under IAS # 14 to report on both **primary** *and* **secondary segments** which clearly *results in* **less** information being reported.

1/1. Examinable syllabus guide for

DECEMBER 2024 TO JUNE 2025 according to ACCA

Inventories

- Measure and value inventories.

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. Overview

IAS # 2 **'Inventories'** prescribes:

A. The accounting treatment for **inventories**;

B. Measuring the cost to be recognised as an asset'

C. Cost flow assumptions ('cost formulas');

D. Write-down of inventory to its net realisable value (**NRV**);

E. Reversals of previously recognised write-down; ***and***

F. Inventory disclosures.

1/3. Scoped out

IAS # 2 does not apply to:

1. **Work in progress under construction contracts** (covered under IFRS Accounting Standard # 15 'Revenue from contracts with customers');

2. **Financial instruments** (covered under IFRS Accounting Standard # 9 'financial instruments');

3. **Biological assets at the point of harvest** (covered under IAS # 41 'Agriculture');

4. Gold in central bank.

1/4. Components of inventories

Inventory is a **current asset** that composed of:

A. Items **purchased** *and* held for resale (merchandise);

B. Finished goods **produced**;

C. Work in progress (WIP); ***and***

D. Materials *or* supplies to be consumed in production process ***or*** in rendering of services.

2/1. Inventory actual cost components

Under IAS # 2 inventory is measured at **actual costs**.

Actual costs of **inventories** include **all** of the following:

1. Purchasing costs

Purchase costs include:

Purchase price;

Plus: Import duties;

Plus: **Irrecoverable** taxes;

Plus: Transportation in;

Plus: Handling costs;

Plus: Any other cost **directly** pertaining to the acquisition of the goods *or* materials;

Minus: **Trade** discounts;

Minus: Rebates.

Illustrative example: Goody purchases motorcycles from various countries *and* exports them to China.

Goody has incurred the following expenses during 2021:

1. Cost of purchases (based on vendors' invoices);

2. Trade discounts on purchases;

3. Import duties;

4. Freight *and* insurance on purchases;

5. Other handling costs relating to imports;

6. Salaries of accounting department;

7. Brokerage commission payable to agents for arranging imports;

8. Sales commission payable to sales agents;

9. After-sales warranty costs.

Required: Determine the costs that are considered under IAS # 2 to be included in the calculation of cost of **inventory**.

Answer: Items 1, 2, 3, 4, 5, *and* 7 are permitted to be included in cost of **inventory** under IAS # 2.

Salaries of accounting department (item 6), sales commission (item 8) *and* after-sales warranty costs (item 9) are **not** considered cost of **inventory** under IAS # 2 *and* are **not** allowed to be included in the calculation of **inventory** cost.

2. Conversion costs

1. Conversion costs are **direct** manufacturing labor **and** manufacturing O.H necessary to convert the raw material into finished product.

2. **Direct** manufacturing labor is **traceable** to units produced *and* easy to calculate.

3. Production **O.H** should be **allocated** to units produced as follows:

A. Fixed production O.H

- Fixed production O.H *such as* equipment depreciation *and* supervisory salaries will be incurred *regardless* of the production level (within relevant rang).

- Fixed production O.H **must** be **allocated** to items being produced based on **normal** production capacity ***or*** **actual** production level ***if*** **it approximates *or* exceeds normal capacity.**

- **Normal capacity** is the <u>expected achievable</u> production level based on the **average** over several periods/seasons, under **normal** circumstances.

- **Normal capacity** takes into account planned maintenance, holydays *and* other normal factors.

Illustrative example: Assume **normal capacity** is 400,000 units and **fixed** O.H amounted to $1m *then*; per unit **fixed** O.H based on **normal production capacity** is $2.50.

Assume **actual** production is one of the following levels:

A. 390,000 units; ***or***

B. 410,000 units; ***or***

C. 300,000 units; ***or***

D. 500,000 units.

Required: Calculate fixed cost per unit produced.

Answer:

Under cases (A) *and* **(B)** fixed cost per unit produced could be **actual** per unit fixed cost because **actual** production level **approximates normal capacity** ***or*** could be $2.50 based on **normal capacity** with the amount of $25,000 **under allocated** in case (A) **charged** to cost of sales *and* $25,000 **over allocated** in case (B) **reduces** cost of sales.

Under case (C) low actual production ***or*** idle plant **will not** result in a higher fixed O.H allocation to each unit. **Under allocated** fixed O.H of $250,000 (100,000 units × $2.50) **must** be recognised as **loss** in the period in which they were incurred preferably in a separate line item in P/L *and* each unit produced would be allocated **fixed** O.H $2.50 based on **normal capacity**.

Under case (D) *when* production is **abnormally high**, the fixed production O.H allocated to each unit will be **reduced** to avoid **inventories** being stated at more than cost *thus*; per unit **fixed** O.H would be $2 ($1m/ 0.50m units) allocated between units sold *and* units remained in **inventory**.

B. Variable production O.H

The allocation of **variable** production O.H to each unit produced is based on the **actual** capacity use because **variable** O.H **varies directly** with the volume of production.

Note: Production O.H costs should be **allocated** based on **rational** *and* **systematic basis** *thus*; O.H costs that **can't** be **reasonably allocated** to units produced are **expensed** once incurred as a period expense *rather than* a product cost.

3. Allocated production costs *other than* manufacturing O.H

Common cost (Joint cost) incurred in manufacturing **joint products** should be **allocated** to each joint product **at split off point** using **rational** *and* **consistent** allocation method *such as* the 'relative sales value' method.

Illustrative example: Omega manufactures products (X) *and* (Y) using a **joint process**. The joint processing costs are $10,000. Assume products (X) *and* (Y) can be sold at split-off for $12,000 *and* $8,000 respectively. After split-off, product (X) is processed further at a cost of $5,000 *and* sold for $21,000 *whereas* product (Y) is sold *without* further processing.

Required: *If* Omega uses **relative sales value method at split off** for allocating joint costs. Calculate joint cost allocated to each product.

Answer:

Joint Product	Selling price at split-off	%	Joint cost allocation	Separable cost	Total cost
(X)	$12,000	60%	10,000 × 60% = 6,000	$5,000	11,000
(Y)	8,000	40%	10,000 × 40% = 4,000	0	4,000
Total	**20,000**	**100%**	**10,000**		

Thus; the common cost (Joint cost) of $10,000 is allocated to the joint products (X) *and* (Y) at $6,000 *and* $4,000 respectively.

Note: Further processing costs ($5,000) are **separable cost** *rather than* joint cost. *Accordingly* it belongs to the product caused its incurrence (product X).

4. Other relevant costs

Costs that are **necessary** in bringing the **inventories** to their present **location** *and* **condition** are part of **inventory** costs. *Such as* special design costs *and* extra processing for specific customer needs.

2/2. Excluded costs

1. The following costs are **not** included in **inventory** costs *rather* it recognised as a period **expenses/losses** *as appropriate* in **P/L** as incurred:

A. Abnormal amounts of wasted materials, labor *or* other production costs;

B. Storage costs for finished product *or* merchandise;

C. Distribution costs;

D. Administrative O.H;

E. Foreign currency exchange rate gain *or* loss (G/L) arising **after inventory** acquisition is recognised in **P/L** in the period exchange rate changed *until* payables are settled;

F. Finance cost; ***unless*** aging **inventory** is involved;

2. *When* **inventories** are purchased on an **extended deferred settlement terms** *such arrangements* contain a financing element that represent the difference between the purchase price for **normal credit terms** *and* the **amount paid**. This difference is recognised as **finance cost** over the period of the financing arrangement.

Illustrative example: Sonata purchased **inventory on credit** the price is payable two years later at \$6,050. Assuming interest rate is 10%.

Required: Determine **inventory** cost.

Answer:

$$P.V = \frac{\$6,050}{(1.10)^2} = \$5,000$$

At the date of acquisition

Dr: Inventory \$5,000

Cr: Trade payables \$5,000

At first year-end

Dr: Finance cost [(\$5,000 × 110%) - \$5,000] = \$500

Cr: Trade payables \$500

At second year-end

Dr: Finance cost [(\$5,500 × 110%) - \$5,500] = \$550

Cr: Trade payables \$550

2/3. Exceptions to actual cost measurement

For **practical purposes** two techniques are **allowed** by IAS # 2 for measuring **inventory** costs ***if*** it results in **approximate** figure to **actual** cost:

1. Standard costs

A. Standard costs can be used to measure **inventory** costs *especially when* the quantities carried in **inventory** are low (*such as* in just in time (JIT) situations) ***if*** the standard is based on **normal** levels of material, labor, efficiency *and* capacity utilisation.

B. The standard should be updated on a regular basis.

2. Retail method

A. Retail method is often used by entities in the **retail** industry *where* there is a **large turnover** of **inventory** items *and* each category has the **same** gross profit margins.

Illustrative example: The following information is available for Silver for the three months ended 31, March, 2022:

Merchandise **inventory** 1, Jan 2022 $900;

Purchases during the quarter $3,400;

Freight-in $200;

Sales during the quarter $4,800

Assume gross margin of this item is 20% of sales.

Required: What should be the merchandise **inventory** at 31, March, 2022 under **retail method** of **inventory** valuation?
Answer: *If* the gross profit margin is 20% of sales, cost of sales equals 80% of sales *then*; ending **inventory** can be determined as follows:

Description	Amount
Beginning **inventory**	$900
Add: Cost of purchases	3,400
Add: Freight-in	200
Goods available for sale	**4,500**
Less: Cost of sales ($4,800 × 80%)	(3,840)
Ending inventory under retail method	**660**

Note: The gross profit percentage used should take into account markups *and* markdowns during the period.

B. Retail method is used *if* it is the **only** practical method of **inventory** valuation.

C. *Even if* **retail method** is used for **inventory** valuations for interim periods, the ending **inventory** should be based on **actual inventory** count *and* valuation.

3/1. Specific identification

Actual unit cost of **inventories** is **required** to be determined using **specific identification** method to **individual items** of **inventory** ***when either***:

A. Items of **inventory** are **not interchangeable;** ***or***

B. Goods are produced *and* segregated for **specific projects** (Job order for example).

Thus; *when* specific **inventory** is **clearly identified** from the time of purchase through the time of sale, the firm's operations may be viewed as a series of **separate** transactions.

3/2. Cost formulas

1. Much of business activity involves goods whose **identity is lost** between the time of acquisition *and* the time of sale **because** the items of **inventory** are **interchangeable** (identical/fungible). In this case the **actual** cost of **inventories** should be measured using ***either* first in first out** (FIFO) ***or* weighted-average** (W.A) cost formulas.

2. Last in first out (LIFO) formula is **not** permitted under IAS # 2.

3. **FIFO** *and* **W.A** cost formulas can be calculated based on **perpetual** *or* **periodic inventory** systems.

Illustrative example (1): Vigo uses the **weighted-average** cost method to value **inventory**.

The following are the purchases *and* sales made by Vigo during 2021:

Purchase date	Description	Selling date	Quantity sold
Jan, 2021	100 units @ $250 per unit	March 2021	150 units
Feb, 2021	150 units @ $300 per unit	Dec, 2021	170 units
Sep, 2021	200 units @ $355 per unit		

Required: Calculate **inventory** costs *and* cost of sales under **weighted average** method assuming

A. Vigo records **inventory** under **perpetual inventory** systems;

B. Vigo records **inventory** under **periodic inventory** systems.

Answer:

A. Cost of inventory under weighted moving average (perpetual)

Date	Purchases			Sales			Inventory balances		
	Q	Price	Amount	Q	Price	Amount	Q	Price	Amount
Jan, 2021	100	$250	$25,000				100	$250	$25,000
Feb, 2021	150	300	45,000				250	**280***	70,000
March, 2021				150	**280**	42,000	100	280	28,000
Sep, 2021	200	355	71,000				300	**330**	99,000
Dec, 2021				170	330	56,100	130	330	42,900
Cost of goods available for sale (450 units)			**$141,000**	**Cost of sales (320 units)**		**$98,100**	**Inventory (130 units)**		**$42,900**

* $70,000/250 units = $280

Note: The per unit average cost **changes** after each **purchase transaction** *so* it is called **moving average**.

B. Cost of inventory under weighted average (periodic)

Under **periodic inventory** system *only* one average is calculated for the entire period as follows:

$$\text{Weighted average} = \frac{\$141{,}000}{450 \text{ Units}} = \mathbf{\$313.33 \text{ per unit}}$$

Cost of sales = $313.33 × number of units sold during the year 320 = **$100,266**

Illustrative example (2): XYZ commenced its operation in 1, Jan, 2021 it uses the **FIFO** method to value its **inventory**. The following are the purchases *and* sales made by the entity during the year 2021:

Purchase date	Description	Selling date	Quantity sold
Jan, 2021	10,000 units @ $25 each	May, 2021	15,000 units
March,2021	15,000 units @ $30 each	Nov, 2021	20,000 units
Sep, 2021	20,000 units @ $35 each		

Required: Calculate **inventory** costs *and* cost of sales under **FIFO** method assuming:

A. XYZ records **inventory** under **perpetual inventory** systems;

B. XYZ records **inventory** under **periodic inventory** systems.

Answer:

A. Cost of inventory under FIFO perpetual

Date	Purchases			Sales			Inventory balances		
	Q	Price	Amount	Q	Price	Amount	Q	Price	Amount
Jan, 2021	10,000	$25	$250,000				10,000	$25	$250,000
March, 2021	15,000	30	450,000				10,000	25	250,000
							15,000	30	450,000
May, 2021				10,000	25	250,000	10,000	30	300,000
				5,000	30	150,000			
Sep, 2021	20,000	35	700,000				10,000	30	300,000
							20,000	35	700,000
Nov, 2021				10,000	30	300,000	10,000	35	350,000
				10,000	35	350,000			
Cost of goods available for sale (45,000 units)			$1,400,000	Cost of sales (35,000 units)		$1,050,000	Inventory (10,000 units)		$350,000

Note: **FIFO** concerns cost follow *rather than* physical flow of units (the price of first purchase is debited first to cost of sales *meaning that* **inventory** units will be valued at last prices ($35).

B. Cost of inventory under FIFO periodic

Cost assigned to ending **inventory** based on **FIFO periodic** is the last purchase price at $35 per unit.

Thus: Ending **inventory** under **FIFO periodic** = 10,000 units × $35 = $350,000

Rule: The cost would be the same under **FIFO perpetual** *and* **FIFO periodic**.

4. According to IAS # 2; an entity should use the **same** cost formula for **all inventories** having **similar nature** ***or*** **similar use** to the entity. For **inventories** with **different nature** ***or*** different **use**; different cost formulas may be justified.

5. A difference in geographical location of **inventories** by itself is **not** sufficient to justify the use of different cost formulas.

4/1.Lower of Cost *and* NRV

At each reporting period, inventories are measured at the '**lower** of **cost** *and* **net realisable value** (NRV)'

1. NRV is the **estimated selling price** in the ordinary course of business less estimated **cost to complete, repair** *or* **modify** *and* **sell**.

Illustrative example: Hero values its inventory at the lower of cost *or* NRV as required by IFRS Accounting Standards. Hero has the following information *regarding* its inventory:

Historical cost $1,000;

Estimated selling price $900;

Estimated costs to complete *and* sell $50;

Replacement cost $800.

Required: What is the amount for inventory that Hero should report on the SFP under the lower of **cost** *or* NRV?

Answer:

NRV = Estimated selling price $900 - estimated costs to complete *and* sell $50 = **$850**

The lower of **cost** *or* NRV is determined by comparing the **cost** of $1,000 to the NRV of $850 *and* using the lower amount. Inventory should be reported at **$850**.

2. Situations in which NRV is likely to be less than cost:

A. A fall in selling price;

B. An increase in the purchase *or* manufacturing costs that is not accompanied by an equivalent increase in sales price;

C. An error in the calculation of purchase *or* manufacturing costs;

D. A physical deterioration in the condition of inventory *due to* damage, obsolescence *or* other factors; *or*

E. A decision as part of the entity's marketing strategy to sell products at less than cost.

Illustrative example: ABC manufactures *and* sells paper envelopes. The stock of envelopes was included in the closing inventory as of 31, Dec, 2021 at a cost of $50 each per pack. Sale price for the inventory at 15, Jan, 2022 was $40 each per pack. Furthermore inquiry reveals that; during the physical stock take a water leakage has created damages to the paper and the glue. *Accordingly* in the following week ABC spends a total of $16 per pack for repairing *and* reapplying glue to the envelopes.

Required: Determine the **NRV** and **inventory** write-down.

Answer:

NRV = Sale price $40 **less** any cost incurred to bringing the good to its salable condition $16 = $24 per pack.

The inventory write-down per pack is the difference between cost $50 *and* **NRV** $24 = **$26** per pack.

3. NRV should be assessed based on the **most reliable information** available at year-end.

4. Fluctuations of sales price *or* cost **after** the reporting period are **adjusting events** ***if*** they **confirm conditions existing** at the year-end.

5. Inventories are usually written down to their **NRV** as an expense/loss in P/L on an **item-by-item basis**. **Similar** ***or*** **related items** may be grouped together in the **same product line** *but* grouping is **not acceptable** based on a whole classification (e.g. materials *or* finished goods) *or* all **inventories** in a geographical segment ***or*** the whole business.

Illustrative example: A company has **inventory** at year-end as follows:

Item	Units	Prime cost	Production O.H	Selling cost	Expected selling price
A	300	$160	$15	$12	$185
B	250	50	10	10	75

Required: Calculate the amount of **inventories** in the SFP in accordance with IAS # 2 *assuming that* item (A) is **unrelated** to item (B).

Answer: Prime cost = Direct material + Direct labor.

Item	Units	Production cost	NRV	Lower	Total inventory
Item (A)	300	$160 + $15 = $175	$185 - $12 = $173	$173	$51,900
Item (B)	250	50 +10 = 60	75 - 10 = 65	60	15,000
Total					**66,900**

Notes:

1. Item (A) is valued based on **NRV** *while* item (B) is valued based on cost.

2. Because items of **inventory** are **not related**, it is **unacceptable** to value **inventory** at $67,500 based on the following aggregation:

Item	Units	Inventory based on cost	Inventory based on NRV
Item (A)	300	300 × $175 = $52,500	300 × $173= $51,900
Item (B)	250	250 × 60 = 15,000	250 × 65 = 16,250
Total		**67,500**	**68,150**

6. The **reasons** why **inventory** is held should be considered *when* valuing **inventory**; some **inventory** items may be held to satisfy a sales **contract** *then*; its **NRV** will be **based on the contract price**. Any additional **inventory** of the **same type** held at the year-end will be assessed according to **market sales prices** available *when* **NRV** is estimated.

7. Inventories of raw materials *and* other supplies **held for use** in production are **not** written down below cost ***if*** the finished products in which they will be used are expected to be sold at *or* above cost. *However when* the cost of the finished product **exceeds NRV** *and* at the same time the **replacement cost** of raw material are decreased, the materials are written down *in such case* to its **replacement cost** because the replacement cost of the raw materials may be the **best measure** of **NRV**.

Remember: inventory is **not** valued at the lower of **cost** *or* replacement cost ***but*** are valued based on the lower of **cost** ***or*** **NRV**.

Illustrative example: Fontana has the following items of **inventory**.

A. Materials costing $10,000 bought for processing *and* assembly for a **profitable special order**. Since buying these items, the cost price has fallen to $7,000.

B. Equipment constructed for a customer for an agreed price of $18,000. This has recently been completed at a cost of $16,800. It has now been discovered that; in order to meet certain regulations, conversion with an extra cost of $5,000 will be required. The customer has accepted partial responsibility *and* agreed to meet half the extra cost.

Required: In accordance with IAS # 2 **'Inventories'**, at what amount should the above items be valued?

Answer:

A. Inventory is valued at the lower of **cost** *or* **NRV** **not** the lower of **cost** *or* replacement cost. Since the materials will be processed for **a profitable sale**, there is no reason to believe that **NRV** will be below **cost**. *Therefore* the **inventory** should be valued at its cost of $10,000.

B. NRV= Contract price $18,000 - entity's share of modification cost $2,500 = $15,500. The **NRV** is below the **cost**. *Therefore* the **inventory** should be held at $15,500 *resulting in* a write down of **inventory** = $16,800 - $15,500 = **$1,300**.

8. NRV must be **reassessed** at the end of each period the **inventory** still on hand *and* compared again with cost. *If* the **NRV** has **risen** (*due to* improvement in sales price) *then*; the **previous write down** must be **reversed** in P/L._**Reversal is limited to the original write-down**.

5/1.Cost of sales

When **inventory** is **sold**, the carrying amount of **inventory** should be recognised as an expense (cost of sales) *when* the related revenue is recognised.

6/1. Required disclosures under IAS # 2

1. Accounting policies adopted for **measuring inventories** (i.e. actual cost, standard cost *or* retail method) **and** the **cost flow assumption** (i.e., cost formula) used;

2. Total carrying amount *as well as* amounts classified *as appropriate* to the entity; common classifications are:

A. Merchandise;

B. Production supplies;

C. Materials;

D. Work in progress;

E. Finished goods.

3. Carrying amount of any **inventories** carried at **NRV**;

4. Amount of any write-down of **inventories** recognised as an expense (loss) in the period'

5. Amount of any reversal of a previous write-down *and* the circumstances that led to such reversal;

6. Carrying amount of **inventories** pledged as security for liabilities.